Lars Rohde: Overview of the Danish economy against the background of global developments

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Association of Local Banks, Savings Banks and Cooperative Banks in Denmark, Copenhagen, 8 May 2014.

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The international economy is recovering. The US upswing is gaining momentum, and the euro area is showing encouraging signs with positive growth in the last three quarters. Now the debt-ridden southern European economies are also beginning to pick up – with Greece as the exception. Interest rates have fallen in these economies, and government yield spreads to Germany have narrowed. The Greek government is able to borrow in the international capital markets again. That has not been the case for nearly four years. Conversely, the emerging economies are slowing down, and there is heightened uncertainty about several economies, including Brazil, Argentina and Turkey, which have seen capital outflows and weakening currencies. But the joker at present is the development in Ukraine. So far the crisis has not had any major impact on the international capital markets, except in Russia, but that may very well change. Nevertheless, the overall expectation is that the global upswing will accelerate this year.

The US economy is now so strong that the Federal Reserve in January began the previously announced tapering of its asset purchases. The Fed has announced that it will reduce its monthly purchases after each meeting of the Federal Open Market Committee, during the rest of the year, provided that the economy develops as assumed. The market expectation is that monetary policy interest rates will not begin to rise in earnest until the 2nd half of 2015, so the low level of interest rates is set to continue for some time yet. Exactly *how* long will be determined by the US labour market.

In recessions, there is normally a tendency for the labour force to shrink, one reason being that some of the unemployed give up the hope of finding work. Conversely, the labour force grows in good times when the chances of finding a job are better. But unlike in the USA, the euro area labour force has actually increased during the economic crisis, partly due to labour market and pension reforms. Although such reforms will strengthen public finances and the growth potential in the long term, they have initially caused euro area unemployment to rise more sharply than the decline in employment would warrant. However, we have now seen the first signs that unemployment is declining in some of the most severely affected member states, such as Spain and Portugal. That is positive.

The high rate of unemployment in the euro area has dampened wage growth. Combined with moderate developments in import prices, including energy prices, this is the main reason for the very low inflation at present. Nevertheless, the rate of wage increase does seem to be rising a little in Germany. Higher German wage growth may facilitate the adjustment process in the debt-ridden economies without jeopardising the ECB's inflation target. Appreciation of the euro helps to keep import prices at bay. In April, prices rose by only 0.7 per cent in the euro area. But overall inflation expectations are well-anchored at around 2 per cent, and the ECB does not see any risk of deflation in the euro area.

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In Denmark, economic activity is also picking up, although the growth pattern has been somewhat uneven. Combined with frequently large revisions of the figures initially published, the substantial quarter-on-quarter fluctuations in the national accounts mean that these figures are of limited value when it comes to determining the exact cyclical position of the economy. But presumably we must accept that and be careful not to overinterpret growth figures for a single quarter.

Private consumption has not recovered yet, although the foundation for increased consumption must be said to be in place. The level of private savings has been high for some years. Interest rates remain historically low, while real wages are set to rise, partly due to low – but nevertheless positive – inflation. And then there are positive consumer expectations and rising net wealth among households. On the other hand, the gross debt ratio remains high, and some households may have a wish for further consolidation. Danmarks Nationalbank's most recent projection operates with sound growth in private consumption in the near term – but on the other hand, we have been saying that for some time without the forecast having materialised.

The forecast is supported by positive indications in the Danish labour market, with falling unemployment and a rise in the number of people in employment, especially in the private sector, although these figures are also subject to uncertainty. Unemployment has declined most strongly among unskilled workers and in the building and construction sector. In Danmarks Nationalbank's view, even a moderate upswing could rapidly cause the labour market to tighten, leading to a shortage of skilled workers and specialists. The first signs of labour shortage are already beginning to emerge in some areas. Although the rate of wage increase in Denmark is moderate by historical standards, the improvement of Denmark's wage competitiveness in recent years seems to be coming to an end. Wage growth in Denmark is now in line with wage growth abroad.

In its most recent projection, from March, Danmarks Nationalbank forecasts GDP growth of 1.4 per cent this year, rising to 1.7 per cent next year. This is above the potential rate, so the capacity situation will normalise towards 2016. If economic growth is to reach a higher level while remaining sustainable, productivity growth must increase. This underscores the need to stay on the path of political reform.

For some time, the already very accommodative monetary policy in the euro area has resulted in low interest rates, which has helped to buoy up the economy. Since the Danish economy is basically healthy with sound balances, Denmark has been able to take advantage of the low level of interest rates. At times we have been perceived as a safe haven among international investors – and during such periods the Danish krone has strengthened against the euro.

With effect from 25 April 2014, Danmarks Nationalbank raised the rate of interest on certificates of deposit by 0.15 percentage point, bringing it back into positive territory. The lending, discount and current account rates remained unchanged. The interest rate increase took place against the background of sale of foreign exchange in the market.

As 3-year loans have gradually been redeemed, the euro area liquidity situation has tightened in recent months. This has caused short-term money market interest rates in the euro area to rise. Consequently, the Danish spread to the euro area has become more negative since short-term money market interest rates are higher in the euro area than in Denmark. The result has been a weakening of the krone. Danmarks Nationalbank has applied its usual reaction function by first intervening in the foreign exchange market and then – when the development proved to be more persistent – raising its interest rates. This reaction function from Danmarks Nationalbank is well-known to market participants.

The current account limits of the monetary policy counterparties were adjusted upwards in connection with the introduction of a negative rate of interest on certificates of deposit in July 2012. This was done in order to reduce the resultant strain on the monetary policy counterparties. The current account limits are now being normalised as the rate of interest on certificates of deposit becomes positive once again. As you know, the purpose of the current account limits is to prevent the build-up of large current account deposits at Danmarks Nationalbank that are immediately available for speculation in a weakening of the krone.

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Since 2008, the pattern of economic growth has been uneven across Denmark. Growth has predominantly taken place in the cities, driven mainly by Copenhagen, where 40 per cent of national wealth is generated. In Copenhagen and environs, GDP is now higher than before the crisis, while this is not yet the case for Denmark overall. Recent years' recovery in both activity and employment has mainly taken place in industries such as consultancy, research, IT and information services and pharmaceuticals. These are knowledge-intensive sectors primarily located in cities. So the sectors that are growing are city-based, as are the ones that will benefit the most from an economic recovery. These are also the sectors that have seen the strongest growth in productivity. Conversely, rising domestic demand is likely to have only a small impact on agriculture and traditional industries – sectors that are strongly represented in peripheral areas. The trend in the business structure described here has been seen for many years and is not a purely Danish phenomenon.

In per capita terms there are also considerable regional differences. But if commuting is taken into account, as well as the rather massive regional redistribution via the public funds, disposable income – and hence consumption opportunities – are far more equally distributed across regions. In 2012, the difference between the average annual disposable income in the Capital Region and in the Region of Southern Denmark was only kr. 10,000. Regional redistribution enjoys broad political support, but all the same, some areas are more challenged than others.

Needless to say, the regional differences in activity have been reflected in employment. Since 2008, the smallest declines in employment have been seen in and around Copenhagen and in eastern Jutland, while the largest numbers of jobs have been lost in western and southern Zealand, Funen and western Jutland. The employment rate is higher in the Capital Region than in other regions, but there are also considerable differences within each region, with urban areas generally faring better than rural areas. Employment has stagnated or declined within more traditional sectors such as agriculture and the parts of the industrial sector that employ relatively many low-skilled workers.

The heterogeneous development in economic activity mirrors a similar development in population growth, with increasing urbanisation. Since 2008, there has been a strong influx of mainly young people and people with jobs to the cities, while pensioners and unemployed people have moved out. Especially the 19–24-year-olds move to the cities, often in connection with education or training. But they increasingly stay there afterwards. Conversely, the share of the population aged 65 or more is lowest in Copenhagen. In Statistics Denmark's population projection this pattern is expected to continue towards 2030.

The geographical distribution of the population is reflected in the housing market. Measured in real terms, house prices in urban areas have risen over time as still more people are living in an area of a virtually given size. In Copenhagen, especially the prices of flats have shown an upward trend. Compared with prices in other northern European capitals, the price level in Copenhagen is not particularly high, but nevertheless we should monitor developments closely. After all, we do not want to see new housing market bubbles. In other areas, house prices are declining, and unsellable houses that are falling into disrepair is a well-known phenomenon. Some areas also have a clear overrepresentation of households with loan-to-value ratios in excess of 80 per cent. Hence potential losses due to defaulted loans are higher in these areas. So far, the recovery in the cities does not seem to have begun to ripple through to the rest of Denmark, as it did during the most recent boom. This means that there is a risk of further impairment charges and losses in the coming years in some areas, such as western and southern Zealand, which have a clear overrepresentation of both mortgage arrears and enforced sales.

The question is to which extent the current development is structural or simply cyclical. Will the recovery in Copenhagen and a few other cities at some point drive growth in other parts of Denmark, or are the cities marginalising the rest of the country? The migration towards urban areas has structural elements. In effect, this represents acceleration of an actually global trend that has existed for a long time. An economic upswing may halt this development, as seen during the most recent boom and in the first half of the 1980s, but is hardly likely to reverse it. At some point, the differences between house prices may become so large that the gain from moving out halts the migration towards the cities, but presumably this will affect only the immediate surrounding areas, i.e. those within commuting distance.

Where is the financial sector in all this? The total lending volume remains high in a long-term perspective. Due to consolidation and debt reduction in the corporate sector and among households, there is no immediate reason to expect strong growth in demand for credit as the economy improves. Households and not least firms have accumulated large savings so the need to borrow is not so pronounced at present. If a turn of the cyclical tide goes hand in hand with subdued demand for loans, the banks must adjust their lending capacity to the level of demand and not engage in an unsustainable credit expansion – we are still suffering from the after-effects of the last one. It is important for future financial stability that you do not weaken credit standards to a too low level. Some local banks have performed well during the crisis, but many still have a low return on equity and high costs. For local banks, the underlying structural migration to the cities is a particular challenge. The weak housing market in areas such as western and southern Zealand is reflected in a clear overrepresentation of households with a loan-to-value ratio in excess of 80 per cent, as well as an overrepresentation of mortgage arrears and enforced sales. Add to this the negative effects on e.g. local trade.

The most important insight must be that we are not likely to return to a situation even remotely similar to that of the 2000s, which some banks likened to the “roaring 20s”. Those days are gone and we should not yearn for them. Banking will not be easier in future. And although some banks may be tempted by the high urban growth rates, the solution is not to embark on a business adventure outside the bank’s natural area. We have seen too many unsuccessful attempts at that. New technological requirements and competition from new angles must also be taken into account.

There is no doubt that the strong growth in bank lending in the period before the financial crisis took place at the expense of credit quality. But in recent years the trend in banks’ domestic lending relative to sector employment has flattened. This indicates a need for further capacity adjustment, which can be achieved either by scaling down activities or by finding a merging partner with a view to boosting profitability.

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Payroll costs make up the most significant item on a bank’s operating budget. Raw earnings levels show that, since the early 1980s, average earnings in the financial sector have tended to be higher than in the rest of the economy. Most of the additional labour earnings in the financial sector reflect the educational composition of employees, the complexity of job functions, geography, etc. Other factors may also justify the relatively high earnings, such as high productivity or high earnings capacity due to efficient utilisation of highly educated, specialised labour. But despite all these explanations it is a fact that the earnings level is high in the sector and that the coming years may see downward pressure on earnings.

Conversely, ownership structures in the financial sector or the absence of strong potential foreign competition could dampen the pressure for efficient cost control and equalisation of additional earnings over time. So it is an important financial sector management task regularly to focus on ensuring a balance between employee earnings levels and productivity and value for the company. The special payroll tax paid by the financial sector since 1988 provides a key incentive in this respect.

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Now I would like to turn to the situation in the agricultural sector, which is of major importance to many small banks. In the years leading up to the economic reversal in 2008, land prices rose more rapidly than house prices. Today it is obvious that there was a genuine “land price bubble” and that prices per hectare were decoupled from the potential gain from cultivating the land. The surge in the prices of land and agricultural properties was partly attributable to an expansion in pig farming, so that land was needed for spreading slurry. Since 2010, the trend in pig production has flattened. At the same time, land prices have dived, although they remain somewhat above the level before the financial crisis, and they still seem to be high relative to the potential return – especially if the level of interest rates normalises.

Rising land prices and property values were pledged as “collateral” for loans from banks and mortgage banks. I have deliberately put quotation marks around the word “collateral” in my manuscript as the current fall in land prices clearly shows that this collateral is of little value for the lowest-ranking creditors. Often loans were granted in the expectation that land prices would rise further, which to some extent contributed to pushing up prices even more. These are the classical characteristics of a bubble: expectations become self-fulfilling for a while – until sentiment changes and the bubble bursts. The result of all this is a heavily indebted agricultural sector and many farms with low solvency ratios. At the same time, the loans are often of the most risky type – short-term variable rate loans without amortisation. In the years leading up to the crisis, loans in Swiss francs without further hedging were also popular. The combination of income in Danish kroner and financing expenses in Swiss francs constituted a further risk element. For some years the risk paid off, but since 2008 the agricultural sector has lost an estimated kr. 10 billion on such arrangements.

The structural adaptation of the agricultural sector is well underway and many people have left the sector. Thanks to the rising land prices, they were often able to pocket considerable profits when they did so. In many cases, the sellers were mature farmers who had bought their properties at considerably lower prices, so that their debts were relatively small and their equity fairly large. According to the Department of Food and Resource Economics at the University of Copenhagen, equity totalling some kr. 55 billion was withdrawn from the sector on this account in the period 2003–10. Furthermore, part of the increase in property prices was pledged as collateral for loans to buy other tangible and financial assets than agricultural properties or equipment and fixtures. In other words, part of the added value has been “consumed “ or used for speculation.

Moreover, there is still a substantial need for a change of ownership in the sector. According to the agricultural weekly Landbrugsavisen, farmers aged 65 or more outnumber those aged 35 or less by 7:1. So it might be worthwhile to consider how sellers of farms can be given a greater incentive to let the money stay in the sector and facilitate a change of ownership. One solution might be to use mortgage deeds, whereby the seller contributes to financing the purchase, thereby reducing the need for loans from banks and mortgage banks. But holders of such mortgage deeds would be among the lowest-ranking creditors, which means that the seller takes on a considerable part of the risk. That might deter some people from choosing this solution. At any rate, it is necessary to consider models for improving agricultural capitalisation.

Owner-farmers still dominate the sector. This means that young farmers must provide large sums of capital to be able to acquire a farm. In Eastern Europe, Danish farmers have successfully set up corporate farming entities. It would be positive if new forms of ownership were also to be introduced in Denmark with a view to attracting new investors. And likewise, there should be an incentive for a certain degree of equity financing. Perhaps inspiration could be sought from other models, such as private equity, so that farmers share both losses and potential gains with external investors. As it is today, the farmer reaps the potential gain, while the bank bears the risk of losses.

In terms of earnings, the agricultural sector is currently in a more favourable position than previously due to a presumably temporary increase in the sector’s terms of trade combined with historically low interest rates. All the same, the sector can post a return on equity averaging only 2–3 per cent p.a., which is not in tune with the risk incurred. And we should bear in mind that the effective interest rate after tax for a mortgage loan is less than 2 per cent at present.

Land prices are scarcely likely to rise in the near term – on the contrary – and the mainly variable rate of interest prevents capital gains on the loans if the level of interest rates normalises. Hence capital gains on assets and liabilities are not likely to boost solvency. The debt problems must be solved via current earnings, and – let us face it – some of the least productive and/or most heavily indebted farmers will presumably have to fold to make way for a new beginning. Most banks can bear such losses. It is best if those who granted the loans also suffer the losses. Losses should not be "socialised". It is not only a question of where the buck would end, it would also be unfortunate in relation to future behaviour among both lenders and borrowers – I am talking of the moral hazard. At the same time, it does not help to sit down and wait for the business cycle to solve the problems. That is not going to happen.

On the other hand, the agricultural sector will still need financing in future – and the banks will continue to play an important role. It should be ensured that loans are granted on the basis of sound economic principles and to owners with sufficient equity.

Thank you for inviting me to speak.